COMMENTS

on Supplementary Proposed Rule
for Establishing Oil Value for Royalty
Due on Federal Leases

Published February 6, 1998 at
63 *Federal Register* 6113, et seq.

April 6, 1998

Mr. David S. Guzy, Chief
Rules and Publications Staff
Royalty Management Program
Minerals Management Service
Building 85, Denver Federal Center
P.O. Box 25165 - MS 3021
Denver, Colorado 80225

VIA E-MAIL AND
OVERNIGHT COURIER

Dear Mr. Guzy:

In response to the subject Notice, Coastal Oil & Gas Corporation, ANR Production Company, CIG Exploration, Inc., and Coastal States Trading, Inc. (collectively **Coastal**) offer the following Comments. These Comments are in addition to, and not in lieu of, Comments previously filed in this matter on May 27, 1997, July 31, 1997, and October 31, 1997.

I. COASTAL

The Coastal Corporation is a diversified energy company with consolidated assets of over $11 Billion. The Coastal Corporation has operations in oil and gas exploration and production, natural gas transmission and storage, natural gas marketing, crude oil refining and marketing, coal, chemicals, trucking, and power generation.

II. BACKGROUND

A. For the background of the Rule prior to February, 1998, see Coastal's Comments of October 31, 1997.

B. Following the filing of Comments on October 31, 1997, the Minerals Management Service (**MMS**) published this Supplemental Proposed Rule (also referred to herein as the **Proposed Rule** or just the **Rule**) in the Federal Register on February 6, 1998, and requested comments to be submitted on or before March 23, 1998. Subsequently, the MMS extended the date for filing comments to April 7, 1998. These Comments are filed In response to that Notice.

III. COASTAL'S POSITION

In Coastal's opinion, the Rule is arbitrary, capricious, and contrary to Federal law. The Rule exceeds the statutory authority granted to the MMS and is in conflict with the terms of existing Federal leases. The Rule: (i) imposes a burdensome and unfair duty to market oil downstream of the lease where none previously existed; (ii) it illegally values oil at a marketing center far downstream of the lease with no compensation to the lessee for associated marketing expenses; and (iii) it unfairly and arbitrarily treats the lessee and its separate corporate affiliates as one and the same business entity.

The Rule does not meet the publicly stated goals of the MMS - to-wit: the Rule does not value oil at or near the lease; the Rule is more complex than the present rules; the Rule is more burdensome to administer than the present rules; and the Rule will result in less certainty and more second-guessing by MMS auditors than the present rules.

It is obvious that the real goal of the MMS in this rulemaking is not to determine the true value of royalty oil at the lease (the IPAA, DPC, API and others have suggested several reasonable methods to accomplish this), but, by unilateral rulemaking, to unlawfully increase Federal royalties by (i) valuing all lease royalty oil at market centers far downstream from the lease, and (ii) disallowing reasonable marketing costs associated with such marketing.

In addition, the Rule will increase audit disputes, administrative appeals, and litigation by incorporating numerous opportunities for MMS auditors to second-guess marketing decisions made by Federal lessees.

For these reasons and the reasons stated in other Comments filed in this matter, Coastal remains strongly opposed to the Rule.

IV. DISCUSSION

A. Contrary to the Government's Position in this Rule, There Is No Duty Under Applicable Law to Market the Government's Royalty Oil Downstream of the Lease at No Cost to the Government.

First, under the terms of past and current Federal leases and applicable Federal law, the lessee does not have an implied duty to market the government's share of production downstream of the lease at no cost to the government, as theorized by the MMS in the preamble to the Proposed Rule. Coastal acknowledges that the Federal lessee has a duty to put the oil in "marketable condition" at no cost to the government, and that there may be a duty to market the oil at or near the lease, but theses duties are far different, and far less onerous, than the new obligation the government is now attempting to impose upon lessees by unauthorized fiat under the guise of rulemaking.

Second, Coastal believes that value is added to oil produced on the lease by its mid-stream affiliate who is responsible for transportation, buy/sells, exchanges, aggregation, blending, storage, and marketing the oil downstream from the lease, and that this added value exceeds the cost of transportation alone, and that, if the government wants its royalty value to be determined downstream of the lease, Coastal (and other Federal lessees) is (are) entitled to be compensated for this added value.

As an example of how unreasonable the Rule is, assume that the government took its royalty share of production In-Kind at or near the lease (after the lessee has placed the oil in marketable condition at no cost). Then assume that the government hired a marketing agent to enhance the value of their oil by arranging for the sale and delivery of the oil to financially sound and reliable third parties at aggregation points or market centers downstream of the lease. Wouldn't it be reasonable to assume that the government would pay the agent a fee for that service in addition to the actual costs for transportation, blending, buy/sells, exchanges, insurance, guarantees, storage, aggregation, or other common mid-stream activities? If this is true (and we know that it is true based upon the fact that (i) private lessees who do not have marketing affiliates pay such fees to private marketing agents, (ii) the government of Alberta pays such a fee to its marketing agents, and (iii) the U.S. government routinely pays consultants and agents who perform services for the it), why then is the MMS proposing in this Rule that Federal lessees must perform these same mid-stream oil marketing services at no cost to the government?

B. Netbacking Is the Most Burdensome and Complex Method to Value Oil.

Although a few lessees with small marketing affiliates may be able to easily trace oil produced from Federal lands to a specific sale, for most other companies with marketing affiliates there is no practical way to trace that oil to a specific third-party sale, and the requirement to do so displays a lack of knowledge of the crude oil trading business.

As an example, Coastal produces approximately 4,900 barrels of oil (including condensate) per day (**Bbl/day**) from Federal leases. Coastal's total oil production (including condensate) from all leases is approximately 17,000 Bbl/day. Coastal sells 5 to 10% of that oil to third party purchasers at the lease, and sells the remainder (90% to 95%) to its affiliate, Coastal States Trading, Inc. (**CSTI**). CSTI's Lease Purchase group, in turn, purchases another 10,000 Bbl/day at the lease (at different prices for varying volumes, types, and grades of oil) from various third party producers. These barrels (now totaling approximately 26,000 Bbl/day) are transported or repositioned to various aggregation points and market centers where it is turned over to CSTI's Crude Oil Trading group.

Coastal's Trading group takes the 26,000 Bbl/day lease purchase oil and in addition purchases in excess of 250,000 Bbl/day at other aggregation points and market centers, all of which is eventually sold to third party purchasers in many different, sometimes complex, deals throughout the month and the following month, some on spot sales, much of it on fixed term sales. Virtually none of these sales are for the same volume, type, and grade of oil as the oil originally produced at the lease.

The Proposed Rule purports to handle this problem by having the lessee average its final sales prices and allocate that average price back to specific leases, less only actual transportation costs. The fact remains, however, that the price received for a large volume of a certain quality and grade oil, guaranteed for delivery, volume, and price for a fixed term, at a market center far removed from the lease, is <u>not</u> the true value of oil at the lease. Arguing that oil at the lease should be valued the same as oil sold at market centers is like arguing that a few Mexican free-range cattle in Chihuahua have the same value, on an individual basis, as a herd of registered Angus cattle in Omaha, Nebraska, less only the actual cost of transportation.

C. The Rule Unfairly and Unlawfully Penalizes Lessees with Affiliates, and Permits the MMS to Second Guess All Lessees' Marketing Decisions.

If one Federal co-lessee sells its share of oil production at the lease to a third party in an arm's-length transaction, the Rule permits (requires) the lessee to pay royalty based upon the gross proceeds paid at the lease.

If a second Federal co-lessee on the same lease sells its share of oil production to its affiliate, this lessee is required to trace that oil to a third party sale by its affiliate, notwithstanding the fact that this lessee may have sold the oil to its affiliate at or above the price the first lessee received for its oil, and further notwithstanding the fact that the affiliate's sale may be for large volumes of a different grade of oil far downstream from the lease under completely different terms and conditions.

Query, what is the "true value" of the oil at the lease? Is it (i) the value the first lessee received at the lease, or is it (ii) the value the second lessee's affiliate received far downstream from the lease?

If the answer is (i), why is the second lessee obligated to pay royalty based upon the enhanced value (without compensation) that its affiliate added to the oil as a result of its mid-stream and downstream marketing activities. Isn't this discrimination against lessees with affiliates?

If the answer is (ii), why isn't the first lessee obligated to market its share of the oil downstream of the lease in the same manner as the second lessee (or is he?), or alternatively, why isn't the first lessee obligated to hire a marketing company to do this for him (at no cost to the government), or to pay royalty on the value he might have received if he had marketed his oil downstream (based on the argument that the price he received reflected deductions for downstream marketing expenses)?

Further queries. Will the MMS auditors, years after the fact, assert that the first lessee breached its duty to market in this case, and assess underpaid royalties and interest, based upon the price received by the second lessee? If the second lessee, who initially sold to its affiliate, subsequently decides to sell to a third party purchaser at the lease instead of to its own affiliate, and pays royalties on the price it receives for that sale (the same price or a higher price than that received by the first lessee), will the MMS auditors assert, years after the fact, that the second lessee breached its duty to market, because it had the ability to market downstream for a higher price but choose not to do so?

D. The Government Continues to Ignore the Fact that There Is an Active Market for Crude Oil At or Near the Lease.

If the government were to take some or all of its royalty share of oil production at the lease and market it, as the IPAA and the API have suggested, the government would learn first-hand that there is indeed a viable lease market for crude oil. In addition to refiners and lease crude oil purchasers, such as Coastal, there are non-affiliated companies whose primary business is to purchase crude oil at the lease, such as Scurlock-Permian.

The prices paid at the lease by willing third-party purchasers to willing producers is the best indicator of the true value of that oil at the lease, not the prices paid at aggregation points or market centers far downstream of the lease.

E. New MMS Form 4415 is Unnecessary and Overly Burdensome.

The Proposed Rule will require all Federal lessees to fill out a new government form each time they make an exchange of Federal oil from a MMS Aggregation Point to a MMS Market Center (information that is not now readily available), and submit that form annually to the MMS. The MMS would then hire more staff to examine all the forms, average the exchange rates for each set of Aggregation Points and Market Centers, and, based upon last year's reported data, publish a MMS approved exchange rate for the current calendar year.

The MMS' exchange rates would then be used only by (i) Federal lessees in the Rocky Mountains who sell to their marketing affiliates (who will have to use the NYMEX index), and, (ii) for all other areas (except California), those Federal lessees who ship their production to their own refineries without an intervening third-party sale (who will have to use Market Center spot prices).

The proposed methodology again reveals the MMS' lack of real-world experience. While this method may work reasonably well for a differential between the Gibson, Louisiana, Aggregation Point and the St. James, Louisiana, Market Center, where all the oil is already Louisiana Light Sweet type and grade, it will not work well for other areas. Exchange rates often are dependent upon local market conditions (refinery shutdowns, pipeline curtailments, pipeline tariffs, etc.) and the oil market in general (supply and demand), and change frequently, often monthly. Exchange differentials are not static, as the MMS believes.

Further, and more importantly, this information is readily available to interested and knowledgeable persons on a as-needed basis in the same manner that Platts obtains the data it uses to publish NYMEX spot market index prices and Market Center spot prices (a method which is apparently acceptable to the MMS) - by telephone surveys of selected traders. This is how crude oil traders now obtain this information. Why then, will virtually all Federal lessees who make exchanges be required to provide data to the MMS which will be obsolete when it is published, and which will be used only by some lessees and a few integrated lessee/refiners?

A much simpler solution, if the MMS is determined to use exchange rate data, would be to let the subject lessee who is using index pricing ascertain the exchange data, and report that rate along with its royalty payment. The MMS would know on a monthly basis from other affected lessees reporting the same data whether or not that rate falls into the range of rates reported by all lessees. In addition, the MMS could spot-check the accuracy of reported exchange rates by a few simple telephone calls.

V. RECOMMENDATION

Coastal endorses the rulemaking goals originally stated by the MMS, to-wit: (1) to value crude oil royalty production at the lease, as required by applicable law and the lease terms; (2) to bring simplicity, certainty, and finality to the crude oil royalty valuation process; and (3) to reduce the administrative costs and burdens (particularly auditing) associated with the crude oil royalty valuation process. Coastal worked diligently this past year with both the IPAA and the API to propose workable rules which would accomplish these goals. unfortunately, the MMS chose to largely ignore those suggestions, and instead proposed the present Rule.

The Rule is an utter failure as judged by the above-stated goals. The Rule is more complex, more burdensome and more expensive to administer, and brings less certainty to the valuation process than the old rules. It is, in fact, a giant step backwards away from the goals.

Coastal believes, therefore, that the only practical way to achieve the MMS' stated objectives is for the government to take all its royalty share of production in-kind instead of in-value. For this reason, Coastal fully supports the Royalty Enhancement Act of 1998 which was recently introduced in the House of Representatives by the Honorable Mac Thornberry (HR3334). Under the proposed bill, the government would take its royalty share of production at the first measurement point downstream of the wellhead or Lease, and through independent marketing companies or agents, sell its share of production to the highest bidder, either at the lease or downstream, whichever the government deems to be in its best interests.

By taking its royalty in-kind, the government is ensured of receiving the true value for their crude oil at or near the lease. Royalty in-kind virtually eliminates royalty valuation issues and their associated problems, perceived or real, thereby eliminating the necessity (and business disruption, time, and expense) for the MMS to conduct lessee and affiliate audits. And royalty in-kind provides certainty, simplicity, and finality for both the lessee and the MMS. In short, royalty in-kind is an idea whose time has come!!

VI. ADOPTION OF IPAA AND API COMMENTS.

Subject to Coastal's Comments above, Coastal also adopts and incorporates by reference the written Comments submitted by the IPAA and the API in this matter.

RESPECTFULLY SUBMITTED on behalf of

Coastal Oil & Gas Corporation
ANR Production Company
CIG Exploration, Inc.
Coastal States Trading, Inc.

By: Robert G. Teeter

Robert G. Teeter
Senior Staff Attorney
Natural Resources Law Department

The Coastal Tower
Nine Greenway Plaza
Houston, Texas 77046-0995

Telephone: (713) 877-1400 (main)
(713) 877-7019 (direct)

Facsimile: (713) 877-3865
E-Mail: Bob.Teeter@Coastalcorp.com